BEFORE THE NEBRASKA PUBLIC SERVICE COMMISSION

In the Matter of the Nebraska Public Service Commission, on its own motion, to make adjustments to the universal service fund mechanism established in NUSF-26.

In the Matter of the Commission, on its own motion, seeking to determine the level of the fund necessary to carry out the Nebraska Telecommunications Fund Act. Application No. NUSF-50

Application No. NUSF-4

POST-HEARING BRIEF OF UNITED TELEPHONE COMPANY OF THE WEST d/b/a EMBARQ

United Telephone Company of the West d/b/a Embarq hereby files its Post-Hearing Brief in this matter. For the reasons set forth in this Brief, Embarq urges the Commission to reject the proposal in this docket to modify the NUSF distribution mechanism. Instead, Embarq requests that the Commission return the NUSF surcharge to a level that is necessary to maintain current distributions or at least to 6.95%. This will allow the Commission additional time to collect the information necessary to make a reasoned and supportable decision. The additional time will also allow the Commission to make a decision that would include its consideration of NUSF issues in other pending dockets.

ARGUMENT

The proposal to dramatically reduce Nebraska Universal Service Fund distributions that is before the Commission in this proceeding is flawed for many reasons. The proposal is not supported by sufficient evidence. And it will ultimately

require the Commission to undertake rate-of-return ratemaking, which this state abandoned 20 years ago and. This is inconsistent with Nebraska law and Commission policy, and will create an enormous amount of additional work for the companies and the Commission. In addition, the proposal will further reduce the ability and the incentive for telecommunications companies to invest in high-cost areas. Furthermore, it is inconsistent with federal law and it has the potential to effect an unconstitutional taking.

The impact of this proposal on Embarq is dramatic. The proposed changes to the NUSF distribution mechanism would result in nearly a 40% reduction to support that Embarq would have received in 2007. As noted by Mr. Harper, to maintain the current level of support for customers in high-cost areas, Embarq would have to raise local rates for each and every one of its Nebraska customers by at least \$6 per month. Embarq urges the Commission not to adopt such damaging measures, and instead raise the NUSF surcharge to a level that will allow it to make a reasoned and supportable decision regarding the issues in this case.

I. THERE IS NOT SUFFICIENT EVIDENCE ON THE RECORD IN THIS PROCEEDING FOR THE COMMISSION TO IMPLEMENT THE PROPOSED CHANGES TO THE NUSF DISTRIBUTION MECHANISM

When an agency makes a decision, it must act within its jurisdiction and its decision must be supported by "sufficient relevant evidence." The record in this case does not contain sufficient relevant evidence to support implementation of the proposed changes to the NUSF distribution mechanism.

¹ *Transcript*, page 346, lines 9-16.

² *Transcript*, page 347, lines 20-24. According Qwest's witness, the proposed reductions would result in rate increases to each of its customers of approximately \$11.

³ Cox v. Civil Service Commission, 259 Neb. 1013, 1024 (2000).

No party has produced evidence which demonstrates that there is a need for a reduction in NUSF distributions. Nor has any party demonstrated that funding requirements or costs to provide service in Nebraska's high cost areas have decreased. Without evidence of these two key facts implementation of proposed changes to the NUSF distribution mechanism, which deprive Nebraska ILECs of a substantial source of funding necessary to provide service in high cost areas, is not supportable.

II. THIS PROPOSAL WILL HAVE THE EFFECT OF CONVERTING NEBRASKA BACK TO RATE-OF- RETURN REGULATION, WHICH THE STATE OF NEBRASKA LEGISLATURE DISCARDED IN 1986

Nebraska law states that "telecommunications companies shall not be subject to regulation by the commission and shall not be subject to provisions as to rates and charges prescribed in sections 75-101 and 75-158." Despite the clear language of this statute, Staff has made clear its belief that the Commission should recognize "other sources" of revenue to determine how much NUSF funding companies should receive. Dr. Rosenbaum uses this rationale in his testimony in an attempt to demonstrate the sufficiency of NUSF funding under the Staff's proposal. In summarizing his pre-filed testimony during the hearing, Dr. Rosenbaum stated, "the fund in my opinion is sufficient *if* the revenue from the fund combined with revenues available from *all other sources* minus *reasonable costs* allow companies to maintain their financial integrity and attract capital." In other words, Dr. Rosenbaum proposes to calculate NUSF distributions using overall revenues from all services, including non-regulated services and even lines of potential business, less Staff's view of appropriate expense levels. If distributions under this formulation are sufficient to produce an acceptable rate of return then, in Staff's opinion, the reduction in NUSF support without any replacement

⁴ Neb. Rev. Stat. § 86-139.

⁵ *Transcript*, page 14, lines 14-19 (emphasis added).

is acceptable. The net result, at a minimum, is to undeniably restrict the earnings level of recipients of NUSF to a commission approved rate of return or perhaps even less. Similarly, Mr. Pursley appears to support thorough review of company expenses:

However, if a company wants to come to the commission and argue that in their case, [NUSF funding] is insufficient, the approach that the commission should take in determining whether it is sufficient or not is to broadly look at revenues available to the company, costs and whether they have a reasonable opportunity to maintain financial integrity and attract investment. And that's the point of my testimony.⁶

The reasoning by Mr. Pursley and Dr. Rosenbaum looks remarkably, and disturbingly, like the analysis a commission might use in a rate case.

Contrary to the approach outlined by the Staff in this case, the Commission in the Aliant merger expressed concern about the merging companies' request to convert from price cap regulation to rate-of-return regulation. According to the order, Commissioner Boyle was concerned "that to allow Aliant to re-enter rate-of-return regulation would be inconsistent with the strides that this Commission has taken to implement the Telecommunications Act of 1996 and would be a huge step backwards." In the Aliant merger, the request to convert to rate-of-return regulation was before the FCC, not the Commission. But that is not so in this case and the Commission is empowered to do the right, and legal, thing and not implement a proposal that will result in *de facto* rate-of-return regulation.

The Commission must not adopt an NUSF distribution mechanism that results in a substantial review of rates for many of Nebraska's telecommunications providers.

And the risk of that is great if companies are deprived of a substantial source of funding, funding upon which they rely to serve Nebraska's high cost communities.

⁶ *Transcript*, page 76, line 23 through page 77, line 7.

⁷ In the Matter of the Commission, on its own motion, seeking to conduct an inquiry into the impact of the pending *Aliant/ALLTEL merger*, Application No. C-2016/PI-26 (June 8, 1999).

This is so because companies will be forced to seek relief from the Commission, as suggested by Dr. Rosenbaum and Mr. Pursley, to make up for the substantial loss in NUSF distributions. To allow this to happen would be contrary to Nebraska law and the policies of this Commission.

III. REDUCTION IN THE EARNINGS CAP FROM 12.00% TO 11.25% WILL HARM THE PUBLIC INTEREST BECAUSE IT EXACERBATES THE DISINCENTIVE FOR TELECOMMUNICATIONS COMPANIES TO INVEST IN RURAL AREAS

One of the primary goals of Nebraska's universal service program is to ensure that customers in rural areas have access to services that are reasonably comparable to those offered in non-rural areas. Because of the remoteness of many of these areas, it is much more costly to provide comparable services to rural customers. So it is even more critical in these areas to ensure that the proper incentives are in place to encourage investment, and that recovery of investments is predictable. As Mr. Pursley stated during cross-examination, "[o]ne of the things that drives rates of return and efficiency are whether companies invest in their network. And one of the overarching goals of this program is for companies to continue to invest in their rural properties."

Reducing the earnings cap from 12.00% to 11.25% will reduce the incentive for companies to invest in rural areas. Mr. Harper illustrates this point in his direct testimony:

A company, when looking at any potential new investment, is likely to produce a business case to evaluate the financial feasibility of the project. That business case will include expected changes to revenues and expenses, including any potential loss of state USF. An investment may decrease expense, and therefore increase efficiency, but may still be rejected because the loss in NUSF support may exceed the decrease in expense. The Commission should be looking for ways to encourage

⁸ Transcript, page 102, lines 17-22.

efficient investment. The current proposal in this docket will not encourage investment in Nebraska.⁹

Embarq's position with respect to the earnings cap is that, as a general matter, it reduces the incentive to invest and is thus counterproductive. However, if there is to be an earnings cap in Nebraska it certainly should not be lowered so that investment is further suppressed. Dr. Staihr's testimony demonstrates that a lowered earnings cap, "puts companies in the position of saying, 'Why should we try to control our costs and save a dollar when, if we do, that same dollar will be taken away from us for 'over' earning?'"¹⁰ Rather, if the Commission wants to increase investment and innovation, it should consider moving the earnings cap in the other direction, or even eliminating it altogether. Nevertheless, as Dr. Staihr opines, "if the system is not going to be changed [the dollar] certainly should not be taken away sooner by using 11.25%."¹¹

- IV. THE PROPOSAL TO IMPUTE FUSF OR INTERSTATE REVENUES IS INAPPROPRIATE AND UNLAWFUL BECAUSE IT WILL RESULT IN A RETURN TO IMPLICIT TELEPHONE SUBSIDIES, WILL CREATE A DISINCENTIVE TO INVEST IN HIGH COST AREAS, IS PREEMPTED BY FEDERAL LAW, CONSTITUTES A TAKING WITHOUT JUST COMPENSATION, AND BECAUSE THIS COMMISSION IS NOT AUTHORIZED BY STATE LAW TO IMPUTE FUSF OR INTERSTATE REVENUES
 - A. The Proposal to Impute FUSF or Interstate Revenues is a Return to Implicit Telephone Subsidies

The result of the Staff recommendations in this case is to increase the reliance on implicit subsidies from other services and customers to maintain affordable local service in Nebraska high cost areas. Both the state and federal law require that universal service funding be predictable and sufficient. Nebraska law states that there "should be specific, predictable, sufficient, and competitively neutral mechanisms to preserve and

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⁹ Direct Testimony of Mark D. Harper, page 9, lines 8-18.

¹⁰ Direct Testimony of Dr. Brian K. Staihr, page 14, lines 6-8.

¹¹ *Id*, at lines 11-12.

advance universal service."¹² Similarly, the federal law directs the FCC to replace the patchwork of implicit and explicit subsidies with "specific, predictable and sufficient Federal and State mechanisms to preserve and advance universal service."¹³

In establishing the NUSF the Commission and the legislature recognized that reliance on implicit subsidies cannot be maintained in a competitive environment. Therefore, an amount of implicit subsidies was moved to an explicit fund to ensure that companies serving high cost areas would continue to receive at least some support in addition to what is recovered in local rates. This Commission has endeavored to reduce less predictable forms of subsidies to advance universal service goals, including reducing intrastate access rates.¹⁴

Relying on FUSF¹⁵ and/or interstate revenues is not predictable. It is much more like an implicit subsidy, i.e. access charges, because it depends on the success and viability of a class of services that are inherently more risky, and in this case services that are not jurisdictional to the Commission. Any proposal that would force companies to seek relief, in the form of implicit subsidies, from reduced NUSF distributions is contrary to the stated universal service goals set forth in Nebraska and federal law. The recommendation by Staff in this case to impute FUSF is such a proposal.

Furthermore, the existing system of implicit subsidies is rapidly eroding. The Commission is aware that competitive pressures are resulting in reductions in access,

¹² Neb. Rev. Stat. § 86-323(5).

¹³ *ATT v. PUC of Texas*, 252 F. Supp. 2d 347, 349 (W. Dist. Tex. 2003), *affirmed, AT&T Corp. v. PUC*, 373 F.3d 641 (5th Cir. 2004)(quoting 47 U.S.C § 254(b)(5)).

¹⁴ See In the Matter of the investigation into intrastate access reform and intrastate USF, Application No. C-1628. ¹⁵ Staff' proposal regarding FUSF appears to incorporate all programs paid through the FUSF mechanism. It also appears to include as an alternative a measure of staff defined interstate "over earnings". Embarq currently includes Federal High Cost Loop Support in the NUSF EARN form process and does not object to offsetting NUSF loop support as it is calculated in this manner. It is the remainder of the FUSF programs and staff interstate earnings proposal to which Embarq specifically objects.

business services, and services in lower cost Nebraska areas.¹⁶ As Mr. Harper explains in his Reply Testimony:

Universal service is in peril in a competitive environment when ILECs must rely on implicit subsidies embedded in rates to ensure that customer rates in high cost areas remain affordable. In other words, as Embarq loses customers in lower cost areas the support embedded in those lost revenues is no longer available to support the costs of serving customer in high cost areas. Embarq is losing customers across its Nebraska service areas to wireless carriers and in two exchanges is facing a facilities based competitor for both residence and business customers.¹⁷

Thus, sufficient NUSF support is more critical than ever to ensure that Nebraska's statutory universal service mandate is met — that all consumers in the state, including "those in rural and high-cost areas," have access to telecommunication services that "are reasonably comparable to those services provided in urban areas and that are available at rates that are reasonably comparable" to urban areas.¹⁸

B. The Proposal to Impute FUSF or Interstate Revenues will Create a Disincentive to Invest in Nebraska High Cost Areas

Like a reduction in the earnings cap, imputation of FUSF will reduce the incentive for companies to invest in rural areas. This is particularly true of advanced services and "new lines of business", which Staff argues can replace revenue from lost NUSF distributions. If a company wishes to invest in a new, risky line of business, it must be able to continue to attract capital to support the investment. Mr. Pursley acknowledged that attracting capital for this purpose would be less likely.¹⁹ It is less likely because of the greater risk associated with the new line of business and the

¹⁶ See also, Transcript, page 45, lines 5-10 and page 345.

¹⁷ Reply Testimony of Mark D. Harper, page 7, lines 6-13.

¹⁸ See, Neb. Rev. Stat. § 86-323(3).

¹⁹ *Transcript*, page 187, line 12 through page 188, line 7.

possibility that revenues generated by the risky business would be counted against the same company's less risky regulated services; in the case of Staff's proposal the FUSF imputation would have this effect.

C. The Proposal to Impute FUSF or Interstate Revenues is Preempted by Federal Law and is not Authorized by State Law

The proposal in this case is to impute into the NUSF distribution mechanism, "the lesser of a compan[y's] interstate revenues including FUSF support above the compan[y's] interstate costs calculate at the federal rate of return of 11.25% or the amount of FUSF support received by the company."²⁰ To the extent that the proposal would rely on interstate revenues to reduce NUSF distributions, ²¹ it would conflict with federal law and the Commission would therefore be preempted from implementing it. And even though the imputation of FUSF alone has been used in Oregon, as Mr. Pursley notes in his testimony, ²² the legality of that practice has not been tested there.

The court, in *ATT v. PUC of Texas*, recently decided a case involving a similar issue.²³ The court found that an attempt by the Public Utility Commission of Texas to assess a surcharge on interstate revenues conflicted with Section 254 of the Telecommunications Act of 1996 (the "Act"). As the court noted in the Texas case, the Act declares:

A State may adopt regulations to provide for additional definitions and standards to preserve and advance universal service within that State only to the extent that such regulations adopt additional specific, predictable, and sufficient mechanisms to support such definitions or standards that *do not rely on or burden Federal universal service support mechanisms*.²⁴

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²⁰ See Direct Testimony of Jeffrey L. Pursley, at page 2, line 44 through page 3, line 2.

²¹ It is not clear from Mr. Pursley's testimony, or any other evidence offered by the Staff, how exactly the proposed mechanism functions *vis-à-vis* interstate revenues.

²² Direct Testimony of Pursley, at page 7, line 8.

²³ ATT v. PUC of Texas, 252 F. Supp. 2d 347, 349 (W. Dist. Tex. 2003).

²⁴ 47 U.S.C. § 254(f) (emphasis added).

The court, in *ATT v. PUC of Texas* found AT&T's argument persuasive that the Texas USF's reliance on the FUSF mechanism itself was the proper subject of AT&T's appeal.²⁵ The court ruled that "the mechanism impermissibly 'relied on' by the TUSF is the FCC-established process of assessing telecommunications carriers' international and interstate revenues to generate the FUSF."²⁶

The proposal in the instant case to impute federal revenues in the NUSF distribution mechanism is similar to the proposal before the Texas federal court. The proposal in this case would rely, and place a burden, on federal assessments to interstate revenues in order to reduce state universal service fund distributions. Under the reasoning in *ATT v. PUC of Texas*, this conflicts with federal law and the Commission is therefore preempted from implementing the imputation of interstate revenues. Likewise, any attempt by this Commission to impute federal USF in the calculation of NUSF distributions would impermissibly rely on and burden the federal universal fund in order to reduce state universal service funding.

In addition, unlike in Oregon, the proposal to impute FUSF is not authorized by Nebraska law. As noted by Mr. Pursley in his testimony, Oregon is one of the few states that imputes FUSF in calculating state USF distributions.²⁷ However, unlike in Nebraska, the Oregon law explicitly grants the Commission the authority to do so. It is a well-recognized administrative law principle that, "[a]n administrative agency only has those powers expressly conferred upon it by statute or constitution and such as are implied by their grant of authority."²⁸ In this case, there is no such explicit grant of authority. Moreover, the proposal potentially involves using interstate sources of funding, which are not jurisdictional to this Commission. Therefore, to suggest that imputing FUSF somehow is implied in Commission's authority would strain credulity.

²⁵ *ATT v. PUC of Texas*, 252 F. Supp. 2d at 351.

²⁶ Id.

²⁷ Direct Testimony of Jeffrey L. Pursley, page 7.

²⁸ See 2 Am Jur 2d Administrative Law § 54.

D. Given the Magnitude of the Reduction in NUSF Funding and the Lack of Evidence Regarding the Effect the Reductions will have, it is Quite Possible that for Many Companies the Proposal will Result in a Taking without Just Compensation

In rate-of-return regulation, companies are entitled to a reasonable rate of return. The law states that a return is not an unconstitutional taking if it allows a company to maintain financial integrity, attract capital, and it is commensurate with returns being earned on investments with equivalent risks.²⁹ Of great concern is the likelihood that the proposal to impute FUSF will result in a reduction in a company's ability to attract capital.³⁰

At hearing, Mr. Pursley received cross-examination regarding a hypothetical corn farmer who experienced a reduction in funding, similar to the reduction that will occur if FUSF is imputed in calculating Nebraska USF distributions.³¹ The cross-examination involved two issues: (1) The proposal to impute federal USF into the NUSF distribution mechanism and (2) Mr. Pursley's proposed alternative to recover lost NUSF, namely that ILECs enter into new lines of business. Critically, Mr. Pursley's answers suggest that imputing federal USF could have two harmful effects. First, imputing federal USF could reduce a company's ability to attract capital. Second, imputing federal USF could reduce a company's ability to do the very thing he advocates will solve the problems caused by reduced NUSF distributions; enter new lines of business.

These flaws in the proposal are illustrated by Mr. Pursley's suggestions about how the Commission and companies might, in the future, deal with a situation where a

²⁹ Duquesne Light v. Barasch, 109 U.S. 609 (1989), citing Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia, 262 U.S. 679, 692-693 (1923); FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944). The applicability of this standard may be questionable, because many areas in Nebraska are subject to competition. See Transcript, page 44, lines 18-23. Even so, it is at worst a minimum standard given the additional level of risk to incumbents in areas that are subject to competition.

³⁰ See supra, footnote 19.

³¹ *Transcript*, page 184, line 11 through page 188, line 7.

company is not receiving sufficient funds from the NUSF to earn a reasonable return on its investments. Mr. Pursley states his opinion that, "if a company wants to come in and claim that the fund is insufficient, I believe it's within the commission's right to ask them to justify their costs."³² But Mr. Pursley seems to rebuke this proposal to allow companies to increase rates to address reduced NUSF funding. When asked about a situation in which a company is facing competition in its main line of business, which is local exchange service in this proceeding, Mr. Pursley states that raising rates, "is not probably a sound economical answer."³³

So if companies lose the ability to attract capital for investment in new lines of business, because of FUSF imputation, and cannot raise rates to account for the lost funding, what are companies to do to remain viable, competitive, and most importantly, continue to provide comparable services to customers in high cost Nebraska communities? There is no clear answer in the Staff's proposal. For this reason alone, the Commission must not implement the Staff's proposal. Instead, Embarq urges the Commission to return the surcharge to a level that will provide the Commission with enough time to thoroughly explore these critically important questions.

³² *Transcript*, page 21, lines 2-6. Although there is no discussion of what is intended here, a pervasive theme in this proposal, it appears Mr. Pursley contemplates a process that would look much like a typical rate case.

³³ *Transcript*, page 185, lines 21-22.

V. EMBARQ'S PROPOSAL

Embarq makes the following proposal to ensure that the Commission is able to make reasoned and supportable decision with respect to the size of the NUSF fund and distributions from the fund to Nebraska companies:

- (1) Do not, at this time, implement any of the proposed changes to the NUSF distribution mechanism.
- (2) Raise the NUSF surcharge to the level necessary to maintain current distributions or at least to 6.95%, which will provide the Commission the much needed time to fully address the issues in this docket.
- (3) To the extent that distributions are reduced after increasing the NUSF surcharge, allow each company to recover those reductions by increasing the revenue stream of its choosing, on a revenue neutral basis.
- (4) Address the issues raised in this docket in conjunctions with those raised in other NUSF dockets, including NUSF-1, C-3554, and NUSF 50 Progression Order No. 2.

Staff has not produced evidence in this case that raising the surcharge is in any way inappropriate.³⁴ And Dr. Staihr's testimony thoroughly and convincingly demonstrates that returning the surcharge to 6.95% will have *no* impact on customers.³⁵ In fact, Dr. Staihr's testimony provides sufficient justification for the Commission to increase the surcharge to above 6.95%, if it deems such action necessary.

³⁴ *Transcript*, page 66, lines 7-11.

³⁵ See Direct Testimony of Dr. Brian K. Staihr.

CONCLUSION

Embarq urges the Commission to reject the proposal in this case to modify the NUSF distribution mechanism following reasons.

- The evidence on the record in this case is not sufficient evidence to justify
 implementing the proposed changes. Given this lack of evidence, the
 Commission cannot know what consequences will result from implementing
 the proposed changes.
- The proposal will have the effect of turning Nebraska back to rate-of-return regulation, which is contrary to state law and policy and will create substantial additional work for both the industry and the Commission.
- The reduction in the earnings cap from 12.00% to 11.25% will harm the public interest because it will exacerbate the disincentive, created by the existing price cap plan, for telecommunications companies to invest in rural areas.
- The proposal to impute federal USF or interstate revenues is inappropriate and unlawful because it (1) will result in a return to implicit telephone subsidies, (2) will create a disincentive to invest in high cost areas, (3) is preempted by federal law, and (4) appears to constitute a taking without just compensation the commission is not authorized by Nebraska law to impute federal USF or interstate revenues.

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Rather than risk implementing a plan that has potential unintended and harmful consequences to Nebraska's telecommunications companies and customers, Embarq urges the Commission to adopt Embarq's proposal. Doing so will allow the Commission to take the additional time necessary to make a reasoned and supportable decision that will be consistent with the public interest and the goals of universal service.

Respectfully submitted this 29th day of November, 2006.

By:____

Steven G. Seglin #13756 Crosby Guenzel LLP Federal Trust Building 134 So. 13th Street, Suite 400 Lincoln, Nebraska 68508 Phone (402) 434-7300 Fax (402) 434-7303 SGS@crosbylawfirm.com

And

William E. Hendricks
United Telephone Company of the West
d/b/a Embarq
902 Wasco Street
Hood River, OR 97031
Phone (541) 387-9439
Fax (541) 387-9753
Tre.Hendricks@Embarq.com

Attorneys for United Telephone Company of the West d/b/a Embarq